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MEMORANDUM

IMPACT OF ESCALATION ON AREA STATES

Iran

Tehran will use the escalated fighting with Iraq to rally the Iranian people and to shift attention from domestic problems. Preoccupation with this issue, however, may delay further discussion of the hostages--and could increase the danger to them--as extremists charge that Iraq is acting as a surrogate for the US. In Khomeini's first statement on the increased fighting, he labelled Iraqi President Saddam Husayn an "American mercenary." The militants, who seem afraid that the National Assembly will seek resolution of the hostage issue, could again call for trials of some of the hostages. []

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The various Iranian political factions probably will curb their differences in public, and the protracted infighting at the top should also fade, at least temporarily. If Iranian losses mount, however, we cannot discount the possibility of significant domestic political changes. Khomeini's own position will probably not be hurt by the crisis as Iranians focus on the threat to the nation. If moderates can convince Khomeini that the survival of the Islamic Republic is at stake, more pragmatic leaders may exploit the situation to weaken the influence of the extremists. Moderates might push for obtaining military spare parts from the West and for appointment of a strong military officer as Minister of Defense. Such a move could weaken the extremists' influence over policy decisions. The extremists, however, will argue for retention of some hostages as insurance against US retribution. []

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In the present highly charged atmosphere, the Khomeini regime is likely to be unable to reach a negotiated settlement on terms acceptable to Iraq. Anyone willing to seek a settlement

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now would be charged with capitulating by extremists. The Iranians may find it politically easier to accept a stalemate while using continued Iraqi occupation of their territory both as a domestic rallying cry and a device to press for redress of their grievances against the US and Iraq in international forums. They may gamble that Arab and international opinion will build on Iraq to limit its military activity. []

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Iraq

Iraq's apparent high morale as a result of the escalated fighting reflects its early successes in retrieving territory ceded under the now-abrogated Algiers Accord. Early success may be emboldening Iraq to more aggressive action. The Iraqi regime, ruled primarily by Sunni Muslims, has successfully portrayed the conflict to its Shia population in ethnic terms--Arab versus Persian. This situation could be reversed if the war becomes protracted, and results in substantial personnel losses. []

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The fighting has renewed Iraq's campaign to pose as the defender of the Arabs and the protector of the Persian Gulf. Iraq has been disappointed, however, that the Arab states, particularly in the Gulf, have failed so far to support Iraq in its conflict with Iran []

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The Iraqis reportedly are also disappointed in the Soviet response to date. Soviet willingness to resupply Iraq with military equipment is a major consideration for Iraq. []

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The Gulf States

Saudi Arabia and the smaller Persian Gulf states see nothing to gain and much to lose if the Iran-Iraq conflict is not contained quickly. They fear that the fighting could:

- spill over into the gulf and threaten the flow of oil, especially if Iraq were to attempt to seize Abu Musa and the two Tunbs islands near the Strait of Hormuz;
- generate violent unrest among their Shia populations, egged on by Iranian agents and propaganda;
- lead to great power intervention and possible confrontation. []

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Despite their antipathy to the Iranian revolution, none of these states wants Iraq to score a decisive military victory. The preferred outcome from their standpoint is a military stalemate that preserves the present precarious balance of power in the Gulf. []

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Gulf states also remain mistrustful of radical Iraq. Kuwait in particular is now worried that Iraq might scrap their border agreement and reasserted its longstanding claim to Kuwaiti territory. []

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If pressed by Baghdad, the Saudis and others would reluctantly throw their support publicly to Iraq. So far, however, they have sought to remain neutral, presumably to avoid arousing the antipathy of their sizable Shia populations. []

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Equally worrisome to these states is the possibility of the US intervening militarily to protect the West's oil lifeline. All the conservative Gulf states would fear that such a step would raise tensions internally and conceivably provoke a superpower confrontation. []

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Economic Impact of the Conflict

The current level of hostilities is already threatening key economic facilities in both countries and shipping along the Shatt al-Arab waterway. Any further escalation of hostilities would severely curtail Iraqi and Iranian imports and could remove 2.0 million b/d of Iraqi oil and 800,000 b/d of Iranian crude and product from the international market. []

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If hostilities spread, imports and exports of all the major Persian Gulf oil producers would be threatened. The international oil market so far has accepted the conflict fairly calmly, in part because of the large overhang of oil stocks accumulated in the last six months. If the conflict goes on much longer, however, anxieties will mount, no doubt leading to strong upward pressure on world oil prices. []

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Iraq. Iraq's economic lifelines run through the Persian Gulf ports. Al Basrah, located on the Shatt al-Arab waterway, is Iraq's principal deepwater commercial port handling 65-70

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percent of Iraq's import tonnage. In addition to general cargo, the port receives most of Iraq's bulk grain imports estimated this year at about 2 million tons including 1.7 million tons of wheat. Wheat is Iraq's most widely consumed grain--about 65 percent is imported. Alternative import routes have only limited capacity and could not compensate for the interdiction of imports via the Shatt al-Arab. Iraq has two other ports but they normally handle only about 25 percent of imports. Umm Qasr, used for general cargo and military deliveries, is located on the Khawr abd Allah near the Persian Gulf and Khor al-Zubair, which is only partially completed, is located further up the river and just west of Al Basrah. []

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Overland alternatives to importing via the Shatt al-Arab are also limited. Baghdad signed an agreement with Kuwait last fall allowing Iraqi bound cargo to be discharged at Mina Shuwaikh, which could easily handle more cargo. An excellent highway from Kuwait connects with the Iraqi road system, but there are no rail links between the two countries. []

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An expanded conflict also threatens seaborne shipments to Kuwait. Expanded use of overland routes through Jordan and Turkey are hampered by limited roads and bureaucratic red-tape. Syria, currently Iraq's major overland connection with outside suppliers, has almost no excess capacity at its ports. Furthermore, Syria is Iraq's political enemy and an outspoken supporter of Iran. []

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Iraq's oil facilities are also threatened. Most Iraqi oil exports pass through two offshore facilities located about 125 kilometers southeast of Al Basrah in the Persian Gulf. Pipelines connecting the export terminals with the producing fields also would be vulnerable to an extension of the conflict. The major southern fields are less than 50 kilometers west of Al Basrah, while the Maysan fields--about 200 kilometers north--straddle the Iraq-Iran border. Al Basrah is also the site of Iraq's largest oil refinery--newly expanded to 140,000 b/d--which process about one-third of Iraq's domestic refined products requirements. []

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Iran. Further escalation of the conflict would compound Iran's already serious economic problems. Present fighting is likely to further reduce needed imports into Iran's Persian Gulf ports, which are already congested due to internal distribution problems. Khorramshahr, one of Iran's major ports

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before the revolution, and Abadan are directly on the Shatt al-Arab. While these two ports handled only about 10 percent of Iran's import tonnage last year, diversion of ships from these ports will add to congestion at Bandar Khomeini and Bandar Abbas. In addition, Bandar Khomeini, Iran's most important non-food port, is located only 100 kilometers from the border, with the entrance to its estuary only 50 kilometers from the Shatt al-Arab. Continued naval engagements could prompt shipowners to refrain from calling at Bandar Khomeini even if fighting does not reach the port itself. []

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Closure of Iran's three other Persian Gulf ports would leave only the ports of Bushehr, a relatively small facility, and Bandar Abbas, Iran's busiest port and the major handler of bulk grains, available for trade. Adding to the problems, Iran's northern overland entry points with the USSR, Jolfa and Astara, are seriously congested because of increased overland trade resulting from Western sanctions. The recent agreement with the USSR to increase trade via overland routes offers no immediate help because of transportation problems in Iran. []

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Fighting around Abadan threatens Iran's largest refinery which accounts for around 60 percent of the country's current refining capacity and provides roughly 50 percent of domestic oil product consumption. Khuzestan Province, which borders Iraq, produces more than 80 percent of Iranian oil. Important oil related facilities, such as the Trans Iranian Pipeline which delivers crude oil to the Tehran and Tabriz refineries, are also located within 100 kilometers of the border. Destruction of these domestically oriented facilities would lead to heating fuel shortages this winter. []

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Kharg Island, Iran's major crude oil export terminal is located about 200 kilometers southeast of the Shatt al-Arab and is highly vulnerable to disruption. A prolonged cessation of Iran's crude and oil product exports would be a serious blow to the economy as oil sales provide over 95 percent of hard currency earnings and over 50 percent of total government revenue. []

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Shipping in the Persian Gulf

The current Iraqi-Iranian conflict has frozen merchant shipping on the Shatt al-Arab and the major ports of both countries served by the waterway--Basra, Fao, Khorramshahr, and Abadan. Ships of all flags will probably stay where they are or put into the nearest port. Ships visiting Khor-al-Amaya

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and Mini-al-Bakr, Iraq's offshore oil loading ports in the northern Gulf, and the nearby Iranian ports of Bandar Khomeini and Bandar Shahpur are probably also subject to a freeze. Prudence and withdrawals of insurance coverage will cause most foreign shipowners to divert vessels currently en route to any of the above ports. The already high cargo insurance rates for vessels calling in Iranian ports were quadrupled in the past week and extended to ships trading with Iraq. War risk insurance premiums on ships trading with non-belligerent ports in the Gulf and their cargoes are also likely to go up. [REDACTED]

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Oil Market Impact

We have no details on how the fighting has affected oil liftings in Iran and Iraq. Normal oil-related activity, however, has almost certainly been disrupted. Even if hostilities end in the next few days without damage to oil loading facilities, the world market will have lost perhaps a week's worth of loadings from Iran and Iraq. At worst, escalated fighting could do major damage to the oil facilities of one or both of the countries. In this event the losses could be large and prolonged. [REDACTED]

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Together Iran and Iraq have been exporting about 3 million b/d through the Persian Gulf ports. Gulf loading accounts for 2 million b/d or about 70 percent of Iraqi oil exports and all of Iran's exports which have been running roughly 1.0 million b/d in recent weeks. Iraq also exports about 1 million b/d to the Mediterranean through pipelines that transit Syria and Turkey. Little underutilized capacity is available through these pipelines; indeed, if the conflict continues, Syria might shut down its pipeline in sympathy with Iran. [REDACTED]

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The impact of lost oil exports from Iran and Iraq would vary among major industrial countries. France and Japan, particularly, import large volumes of oil from both Iran and Iraq. During first-half 1980, Japanese imports from Iraq and Iran totalled 1.1 million b/d, or 20 percent of imports. France imported 630,000 b/d, or 24 percent of imports. Italy, West Germany and the United Kingdom also import between 10 and 15 percent of their total imports from Iran and Iraq. US imports from Iran and Iraq account for about 1 percent of total oil imports. Among developing countries, Brazil is a large importer of Iraqi oil, deriving about 50 percent (500,000 b/d) of its total import needs from Iraq. [REDACTED]

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If supplies from both Iran and Iraq are disrupted for a sustained period the oil market would quickly tighten. With Saudi Arabia still producing at 9.5 million b/d, only about half the potential 3 million b/d loss could be offset by increased output elsewhere. Most of this would have to come from Kuwait, Abu Dhabi, and Libya. Although free world inventories are quite high, we doubt that oil companies would be willing to draw down stocks fast enough to eliminate strong upward price pressures. Much will depend on their view of how long the conflict will last and their assessment of damages to oil-related facilities in the area. [REDACTED]

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Major Developed Countries
Dependence on Iran and Iraq

(thousand b/d)								
	<u>Imports from Iraq</u>	<u>Percent of Consumption</u>	<u>Percent of Imports</u>	<u>Imports from Iran</u>	<u>Percent of Consumption</u>	<u>Percent of Imports</u>	<u>Imports from Iran and Iraq</u>	<u>Percent of Consumption</u> <u>Percent of Imports</u>
United States	50	Negl.	1	30	Negl.	Negl.	80	Negl. 1
Japan	360	7	7	710	14	13	1,070	21 20
Canada	10	1	2	5	Negl.	Negl.	15	1 2
West Germany	30	1	1	330	12	12	360	13 13
France	545	24	21	80	4	3	625	28 24
Italy	255	13	10	15	Negl.	1	270	13 11
United Kingdom	110	6	12	25	1	3	135	7 14